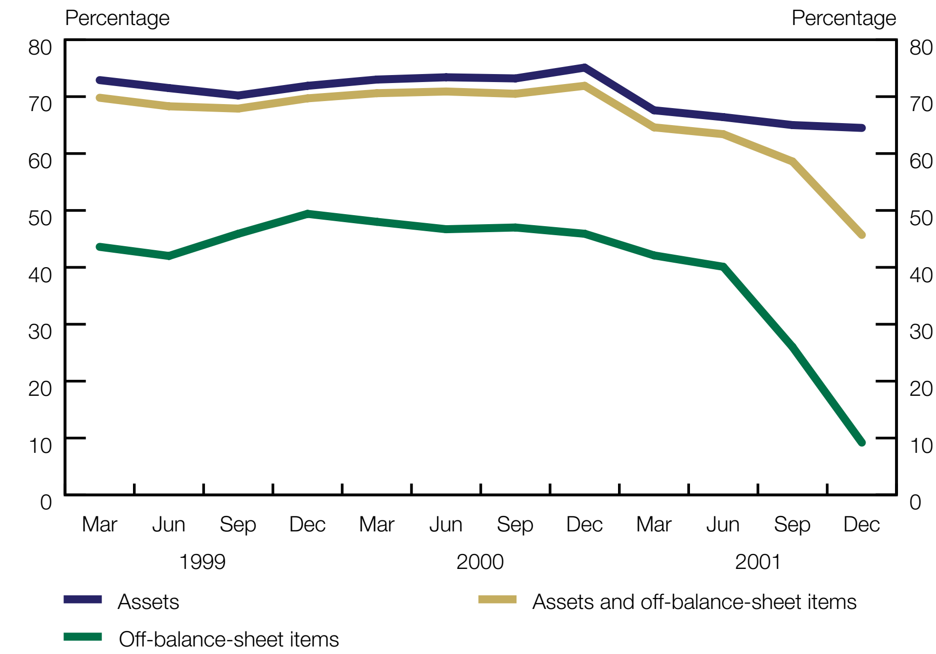
3.3 PROFITABILITY

An evaluation of the profitability of banks involves an assessment of the quality of income and the long-term sustainability of the activities that generate the income. For this reason, the analyses focus on the following aspects:

analysis focus on the following aspects

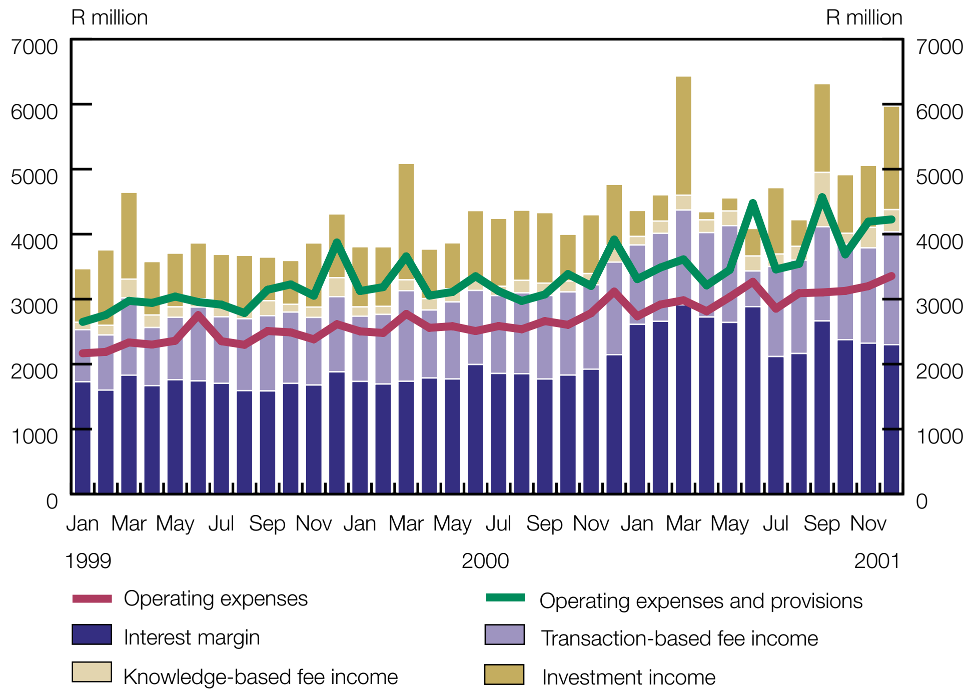
- Quality of earnings (riskiness of earnings).
- Balance in the various sources of income (such as, a good spread of income sources).
- Nature of income (such as, the intermediation function, advisory services or trading activities).
- Integrity of the information (whether the income statement is consistent with the balance sheet).

FIGURE 14: RISK PROFILE OF ON- AND OFF-BALANCE-SHEET ITEMS



- Profitability of assets and effectiveness of activities versus cost control and cost optimisation.
- Balance between the effort expended on activities and the income generated therefrom.
- Structural changes in profitability during the year.

FIGURE 15: COMPOSITION OF THE INCOME STATEMENT



intermediation function again constituted the main source of income

As can be seen in Figure 15, the intermediation function again constituted the main source of income for banks. The intermediation function consists of interest margin (an average of 3,3 per cent of total assets for the year, as opposed to 2,9 per cent in 2000) and transaction-based fee income (an average 1,8 per cent of total assets for the year, as opposed to 1,9 per cent in 2000). As can be observed from Figure 15, the income derived from the intermediation function (R46,7 billion) was generally just sufficient to cover the sum of operating expenses and provisions (R45,2 billion). It is thus clear that the generation of additional income (that is, from investments in Government stock and Treasury bonds, as well as knowledge-based fee income derived from trading activities, and agency type and advisory activities) remains critical to ensure the continued profitability of banks. Fee income and investment and trading income earned during the year were on average equivalent to 2,1 per cent and 1,0 per cent, respectively, of total assets (as opposed to 2,2 per cent and 1,6 per cent, respectively, during 2000).

Interest income increased by about 12,4 per cent for the year, which was 9,2 percentage points higher than the increase of 3,2 per cent in interest expense. The net result thereof was that the interest margin grew by 37,4 per cent (2000: 7,8 per cent). Interest derived from mortgage bonds and overdrafts and loans constituted 33,2 per cent and 30,1 per cent, respectively, of total interest income (as opposed to 35 per cent and 32,5 per cent, respectively, during 2000).

The main component of interest expense was interest on demand deposits and fixed and notice deposits. Interest paid in respect of demand deposits constituted 33,9 per cent (2000: 36,1 per cent) of the total interest expense, whereas interest paid on fixed and notice deposits constituted 28,9 per cent (2000: 25,7 per cent) of the total interest expense for the year.

FIGURE 16: INTEREST MARGIN

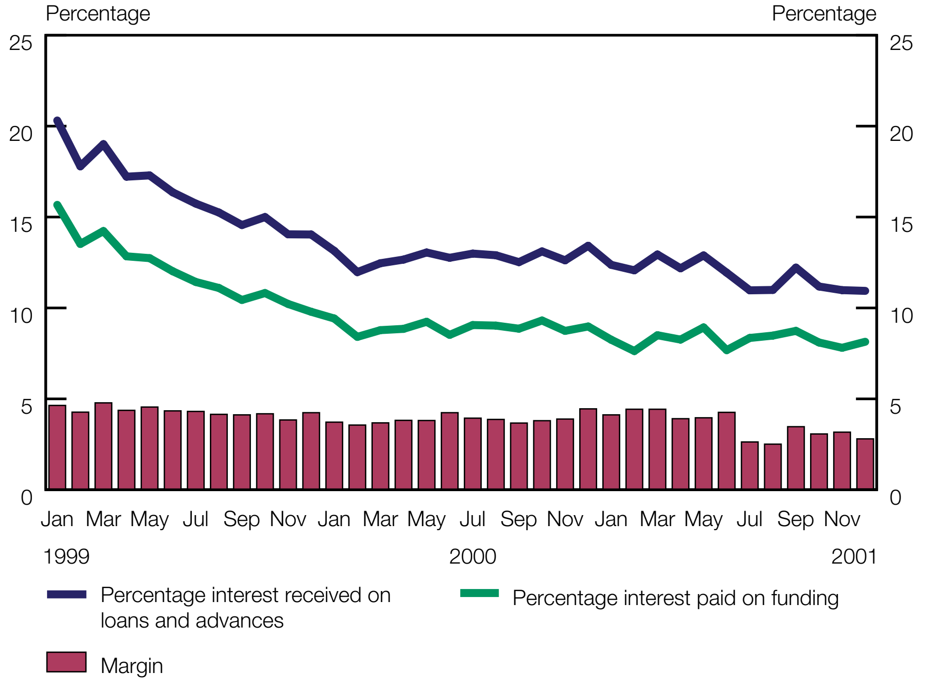
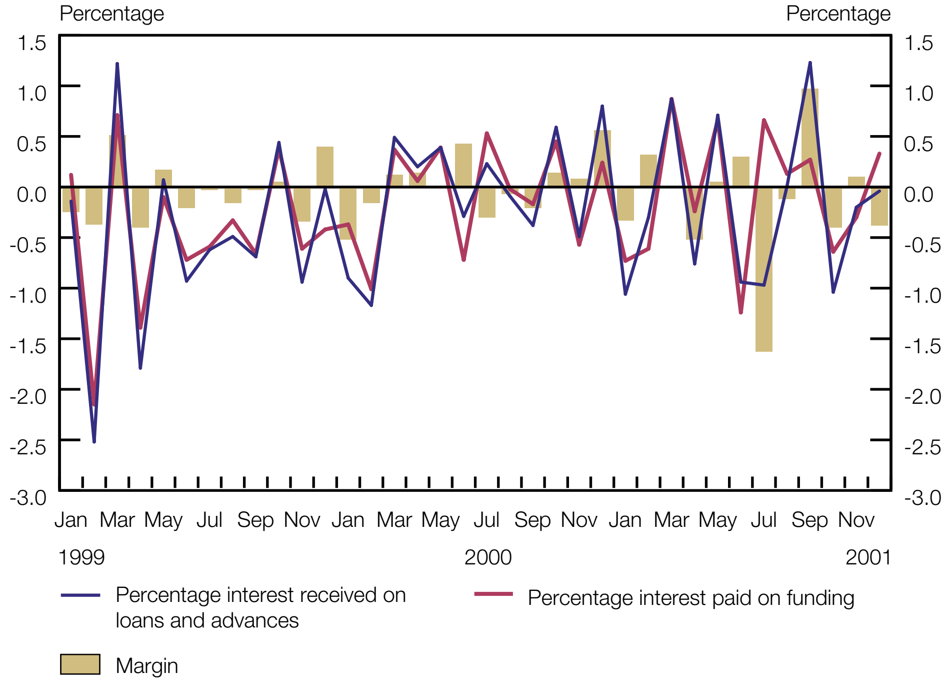


Figure 16 graphically displays the interest margin of the banking sector for the period from January 1999 to December 2001, whereas Figure 17 represents the percentage-point change in the components of the interest margin for the aforementioned period. As can clearly be seen from Figure 16, the interest margin for the year was on average higher

(4,2 per cent) than in 2000 (3,9 per cent). For the 12 months ended December 2001, the average interest margin was 3,5 per cent, compared to 4,3 per cent in 2000 and 4,2 per cent in 1999. An analysis of the relative monthly percentage-point change in the underlying components, as well as in the interest margin (Figure 17), displayed clear seasonal tendencies.

FIGURE 17: PERCENTAGE-POINT CHANGE IN INTEREST MARGIN



operating expenses increased by 15,1 per cent

The operating expenses of the total banking sector increased by 15,1 per cent (2000: 10,2 per cent) in 2001, mainly as a result of an increase of 13,8 per cent in total staff expenses, which accounted for about 55,0 per cent of total operating expenses. The increase in total staff expenses, however, was not due to an increase in the number of people employed. This is confirmed by Figure 18, which graphically displays the percentage change (meas-ured over a 12-month period) in total staff expenses, the number of people employed and the number of branches for the past three years. For the year 2001, employment in the banking sector decreased by 0,2 per cent, whereas the number of branches increased by 14,1 per cent compared to the year before.

Growth in operating expenses was also boosted by an increase in administrative expenses. Compared to the previous year, administrative expenses increased by 18,4 per cent and accounted for 47,6 per cent of total operating expenses.

lower efficiency in the banking sector

Growth in total income of 11,3 per cent could not offset the increase in operating expenses (15,1 per cent), resulting in lower efficiency in the banking sector (see Figure 19) during the year under review.

FIGURE 18: GROWTH IN STAFF EXPENSES, NUMBER OF PEOPLE EMPLOYED AND NUMBER OF BRANCHES AND AGENCIES

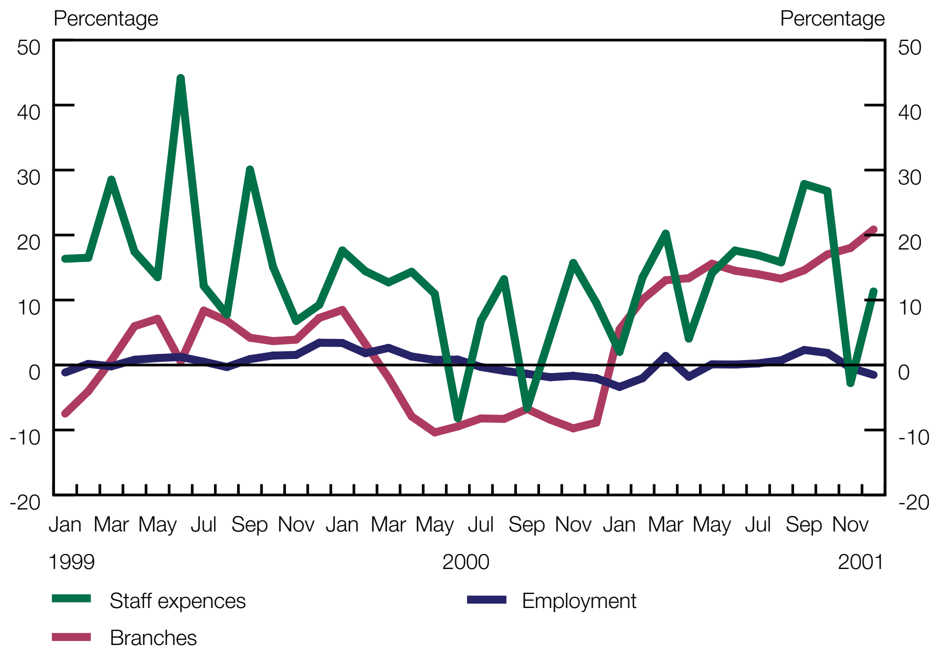
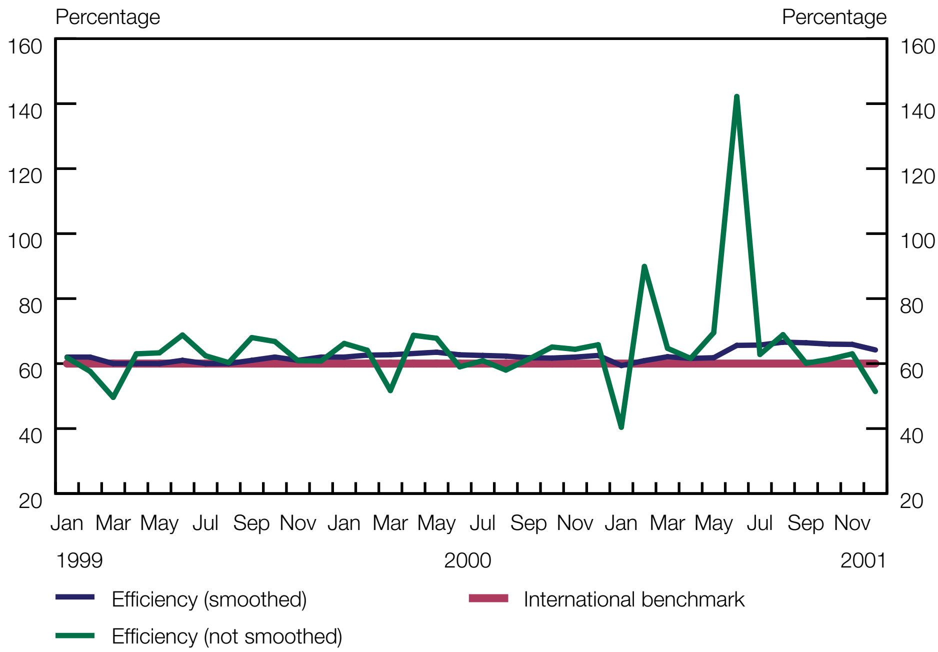


FIGURE 19: EFFICIENCY OF SOUTH AFRICAN BANKING SECTOR



The efficiency of the banking sector can be determined by expressing operating expenses as a percentage of total income. Currently, the international benchmark for efficiency is 60 per cent. In other words, banks that have an efficiency ratio of above 60 per cent are regarded as less efficient.

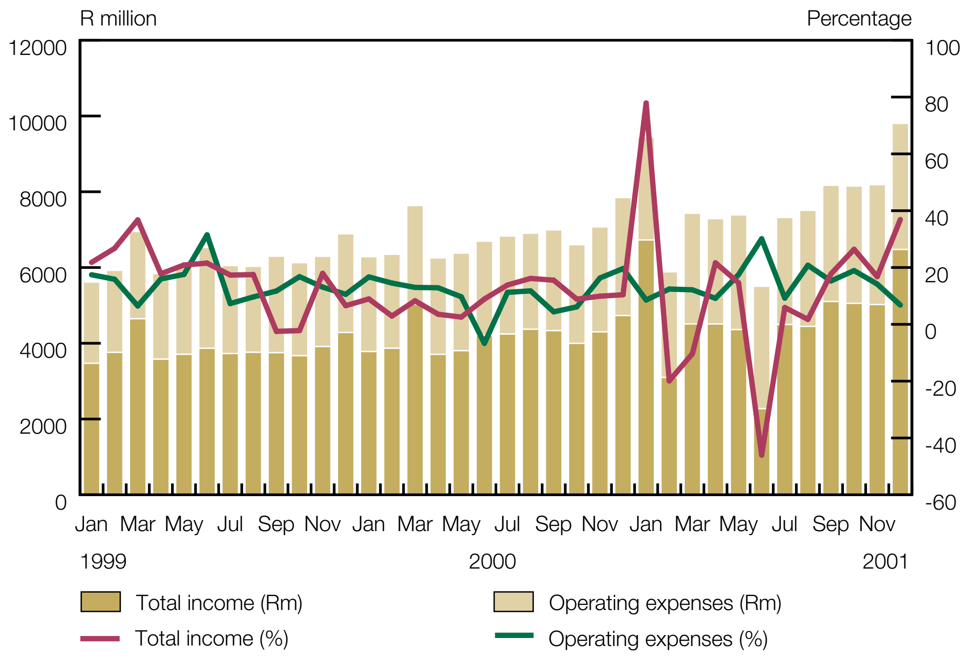
high volatility in efficiency was due mainly to the implementation of AC 133 by some banks

Figure 19 reflects the efficiency of the South African banking sector for the past three years. The high volatility in efficiency for the year 2001 was due mainly to the implementation of Accounting Standard AC 133 by some banks in January 2001. In terms of the disclosure requirements of AC 133, banks are required, in respect of financial-year periods commencing on or after 1 January 2001, to reflect the net mark-to-market adjustments of investments (fair-value accounting) in their financial statements, as opposed to the equity accounting (book value or purchase price) done previously.

The Accounting Practice Board, however, had reconsidered the implementation date of AC 133 and announced that AC 133 would become effective for financial years commencing on or after 1 July 2002. The objective of the delayed implementation was to enable companies to improve their business practices and systems and to complete the necessary training. Some banks, however, had already implemented AC 133 and reported data in accordance with the requirements of AC 133 for 2001. For the year as a whole, efficiency, at 64,2 per cent, was lower on average (smoothed over a 12-month period) than in the previous year (2000: 62,5 per cent).

The actual values of, and the percentage growth in, the determinants of efficiency are graphically displayed in Figure 20.

FIGURE 20: DETERMINANTS OF EFFICIENCY



banks with assets above R5 billion, but below R10 billion were the most efficient in December 2001

Figure 21 graphically displays the efficiency of the various categories (according to asset size) of banking institution for the year ended December 2001. The figure clearly shows that banks with assets above R5 billion, but below R10 billion, in value were the most efficient in December 2001, with an efficiency ratio of 45,1 per cent, followed by banks with assets above R100 billion, with an efficiency ratio of 46,4 per cent. The least efficient were banks with asset values above R50 billion, but below R100 billion, and banks with asset values below R1 billion. It should be borne in mind that these figures are compiled for one month at a time. Because operating expenses and total-income components can fluctuate drastically from one month to another, the average efficiency ratios of different banks would fluctuate accordingly.

average efficiency ratios fluctuate from one month to another

FIGURE 21: EFFIENCY OF BANKING INSTITUTIONS ACCORDING TO ASSET SIZE – DECEMBER 2001

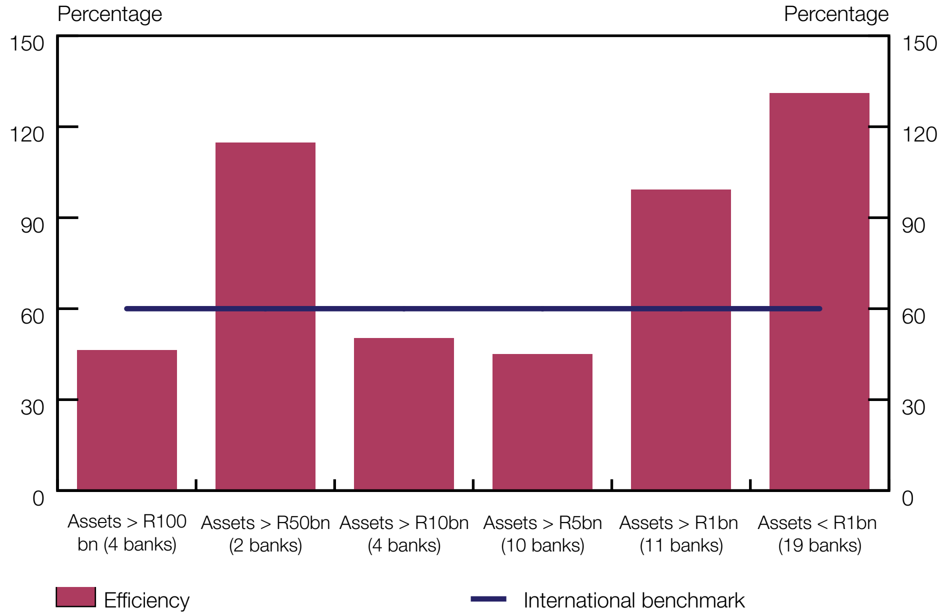
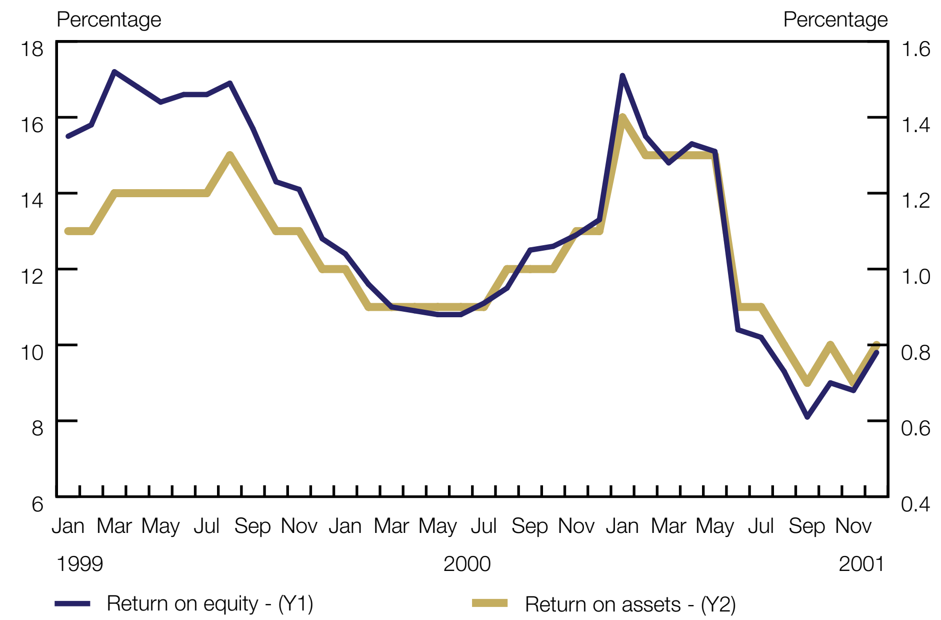


FIGURE 22: PROFITABILITY (12-month smoothed average)



The banking sector achieved a before-tax return equivalent to approximately 1,0 per cent of total assets (2000: 1,5 per cent). An after-tax return equivalent to approximately 0,7 per cent of total assets (2000: 1,1 per cent) was reported for 2001, whereas an after-tax return equivalent to approximately 9,2 per cent was reported on net qualifying capital and reserves (2000: 12,0 per cent).

marked deterioration in both ROA and ROE was due mainly to losses in the investment portfolio in terms of AC 133

The trends (calculated on the basis of a 12-month moving average) in return on equity (ROE) and return on assets (ROA) for the past three years are graphically displayed in Figure 22. After a marked deterioration in both the ROA and the ROE during the period from September 1999 until June 2000, both the ROA and the ROE improved noticeably until January 2001. This improvement was due mainly to a higher net income after tax resulting from slower growth in operating expenses. From January 2001, however, a marked deterioration in both ROA and ROE, however, can clearly be detected from Figure 22. This deterioration was due mainly to losses in the investment portfolio reported by some banks in terms of AC 133.

FIGURE 23: PRODUCTIVITY

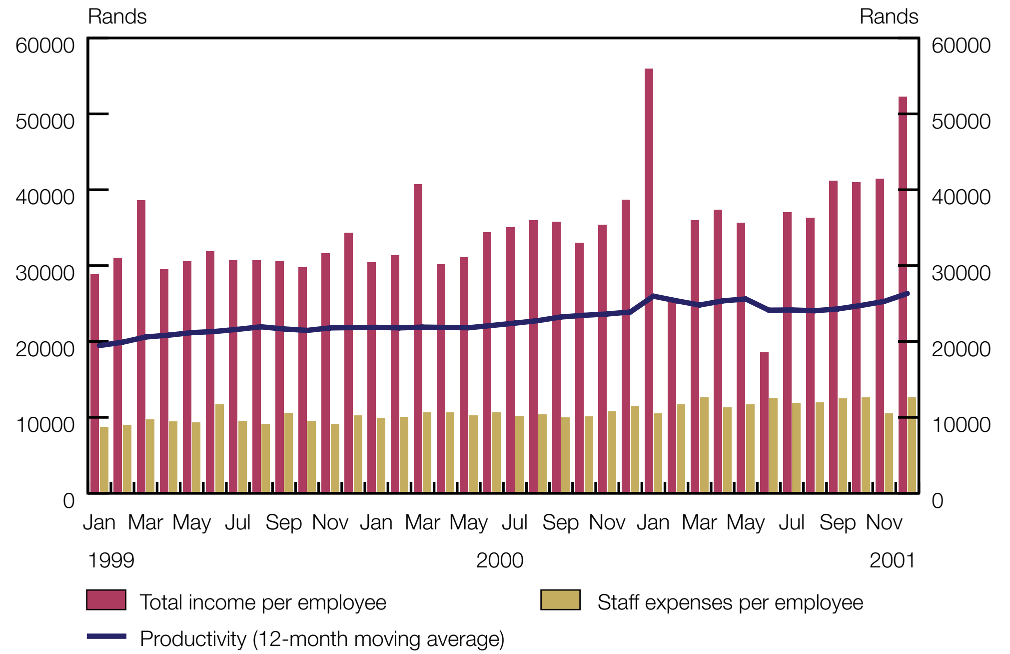


Figure 23 graphically displays the productivity of the banking sector for the past three years, measured by comparing the expenditure on employees with the amount of income generated. During the year under review, the total income generated per employee was on average equivalent to R38 200, as opposed to R34 300 in 2000. Staff expenses per employee, on the other hand, were on average R11 900 in 2001, as opposed to R10 400 during 2000. Also reflected in Figure 23 is the average (smoothed over 12 months) net income generated per employee. The net income generated per employee increased from R23 900 to R26 300, indicating that the productivity of employees in the banking sector improved during the year under review.

productivity of employees improved